

Realty Trust Review

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INVESTMENT OUTLOOK: PICKING REALTY TRUST STOCKS IN A DEPRESSED MARKET

For the past two months, in the light of ever-increasing interest rates, we have counseled you to wait for realty trust stock prices to fall, opening up a buying opportunity. Following October Massacre II, the looked-for opportunity arrived, and using the criteria of potential appreciation combined with income, we feel that several of the larger property trusts are well situated for current purchase. While individual issues in other groups may be attractive, this is the only group which meets both conditions.

The table at the top of page 2 illustrates the story in the property trusts. As a group, these 11 trusts have largely high-quality properties with superior management and a proven earnings record; only two--Virginia and

San Francisco--omitted their dividends for a period beginning in 1974. But despite their records, and the awareness that trust assets have often proved to be worth more than book value, these trusts as a group are currently trading at 5.4% below adjusted book value--inflated by the substantial premiums at which two of the trusts--Pennsylvania and Washington--are trading above their book value. Indicating their appreciation potential, the shares are trading at 19% below their 1979 highs, compared with a decline of 9.5% in the Dow Jones Industrial Index, and are yielding 8.9%, even though annualized dividends are up 30% from the 1973 year-end level, as compared to a 60% increase in share prices over that period. The annual growth rate of the dividend stream, arrived at by plotting a straight line through the dividends paid over the seven-year period, averages 4.6%, a figure which can be used to project future dividends, although ac-

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PRICE AND DIVIDEND PERFORMANCE OF ELEVEN EQUITY TRUSTS

Trust	Price	% change from 1979 high	12/31/73	Book Val.	% Pr. to Bk.	Ann. Div.	Yield	%Div.chg. from '73	Growth Rate*
Am. Equity#	\$9.75	-25.0	NA	\$11.08	-12.0	\$1.60E	15.4	+77.8	+12.9
Denver RE#	19.25	-16.3	+191.0	17.12	+12.4	1.00	5.2	+66.7	+ 4.8
Federal#	14.13	-21.0	+52.7	13.87	+ 1.8	1.40	9.9	+52.2	+ 8.8
Fst. Union#	13.88	-28.8	+33.7	16.60	-16.4	1.20	8.6	+27.7	+ 3.6
Fla. Gulf#	14.00	-18.8	+ 7.7	20.36	-31.2	1.28	9.1	-19.0	- 3.2
Gould Inv#	12.25	-16.2	+58.1	18.83	-34.9	0.96	7.8	+13.6	- 0.6
Penn REIT	21.25	- 8.6	+77.1	14.05	+51.2	1.65	7.8	+57.1	+ 7.1
REIT Amer.	17.63	-18.0	+11.9	22.61	-22.0	1.60	9.1	+14.3	+ 0.1
San Fr. RE#	20.88	-15.2	+65.3	25.03	-16.6	1.60	8.4	-12.1	+ 0.6
Virginia#	10.00	-29.8	+25.0	14.45	-30.8	0.80	8.0	-36.0	0.0
Washington#	26.75	-16.1	+81.4	18.44	+45.1	2.12	8.4	+89.3	+16.7
Average	16.34	-19.43	+60.3	17.49	- 5.4	1.38	8.9	+30.1	+ 4.6

- Trusts reported on a cash flow basis; book value includes accumulated depreciation.

* - Growth rate determined by straight-line dividend trend.

E - Estimated.

curacy will be affected by changing business conditions.

Federal Realty (FRT-ASE) is currently trading at its two-year low, virtually at book value. Federal's portfolio consists of quality properties, mainly shopping centers and apartments in the Washington, D.C., area, although the trust is expanding in the Southeast. Federal has one of the highest returns on property investments in the industry. Shopping centers provide about 75% of cash flow; Federal is planning to buy six shopping centers from Amterre and still expects to close the sales by year-end. The acquisitions will be financed through utilization of the trust's bank credit lines, which were recently paid down by the use of the proceeds from a \$3.2 million, 27-year mortgage on a North Carolina shopping center. By year-end, Federal will have tripled its real estate investments in the past three years. Currently yielding 9.9%, (part of the 1979 dividend should be a tax-free return of capital) with a dividend growth rate of 8.8% and considerable upside potential, the No. 1-ranked shares are a strong buy.

First Union (FUR-NYSE) is trading at 29% below its 1979 high and at 16%

below book value. With \$213 million in assets, the trust is the largest self-administered real estate equity trust in the U.S., investing mainly in high-rise office buildings and enclosed shopping malls. First Union is aggressively expanding its portfolio, making new investments totaling \$24 million in the first eight months of 1979; one office building was sold during the year for a gain of about \$900,000.

First Union recently offered \$35 million of 8 3/4% subordinated debentures convertible into 1,944,000 shares at \$18 each. Approximately \$30 million of the proceeds was earmarked to repay short-term bank debt and commercial paper, with the balance to be used to meet existing commitments, mainly purchase obligations with respect to an office building and two malls. While the immediate effects of the reduction of short-term debt will benefit the trust's earnings, the potential dilution (the shares traded above \$18 as recently as September, 1979) somewhat lessens the appeal of the shares, and certainly makes an attempted take-over much less likely, even though Unicorp Financial (Canada) owns 4.5% of the shares and plans on increasing its stake to 10%. At current price levels, however, with aggressive

management and an 8.6% yield, the No. 1-ranked shares remain a buy.

American Equity (AEQTS-OTC), is currently yielding 15.4% on a price 25% below its 1979 high and 12% below book value. The trust was reporting an operating deficit as recently as the first quarter of 1977, after reporting losses in the preceding three years, although it continued to pay a dividend throughout that period. Since early 1977, earnings have skyrocketed as the apartment and motel markets in its areas continued to boom. American Equity has over \$60 million in assets located mainly in the Sunbelt, including 50% in Texas.

The trust has no interest rate exposure; its \$38 million in debt is all mortgages with fixed rates. It earned \$1.67/share in the first nine months of 1979, of which \$1.09 was asset sale gains. Part of the \$1.10/share distributed for that period will be capital gains. The \$1.60/share dividend shown for the year estimates that the dividend in the final quarter will equal that of the preceding quarter; with that figure, American Equity's dividend has had an annual growth rate of 12.9% over the past seven years, the second best of the group. The shares are No. 2-ranked for higher risk income with lower appreciation potential.

Washington REIT (WRE-ASE) has by far the best dividend growth rate of the group at an annual rate of 16.7%. The shares currently yield 8.4% on a price 16% below the 1979 high but at a premium of 45% over book. In August, 1979, the trust effectively traded up \$1.3 million equity in an apartment building for \$6.7 million equity in two office buildings in an exchange that required only a \$110,000 immediate cash payment and avoided \$2.4 million in capital gains taxes. The apartment building was valued at \$9.9 million while the two office buildings were valued at \$13.3 million. WRIT's portfolio is now approximately 1/3 office buildings, 1/3 apartment buildings, and 1/3 shopping centers, 95% of which are with-

in an hour of the trust's Bethesda office. The trust had wanted to augment its office building holdings because in the Washington, D.C., area, office buildings have annual rent increases keyed to the consumer price index, and since tenants pay utility costs, as opposed to the landlord in apartment buildings.

WRIT is conservatively financed, with \$15 million debt (all mortgages following the redemption of the remaining convertible debentures) over \$17 million in shareholders equity. The No. 2-ranked shares are a buy for aggressive management, quality income and condo potential in remaining apartment buildings.

Pennsylvania REIT (PEI-ASE) is the other trust in the group trading substantially above book value, at a premium of 51% (it must be remembered, however, that Penn's book value has not been adjusted upward). The shares, with a dividend growth rate of 7.1%, are yielding 7.8%, rather low for the group, reflecting a share price not far below its 1979 high. The trust's properties are mostly shopping centers and apartment buildings. Shopping center holdings have been increased in recent years, notably with the \$13.6 million purchase of a half-interest in a mall in Allentown in 1977; no new centers were added in the fiscal year ended in August, 1979. Earnings for the year totaled \$2.18/share, up 57% from the preceding fiscal year operating earnings of \$1.42/share.

Penn has some interest rate exposure: its \$53 million debt (over \$22 million equity) is 89% mortgages, and the rest is bank lines of credit. The shares are No. 1-ranked for long-term growth and income; the stock remains high relative to earlier levels because it was undervalued earlier.

REIT of America (REI-ASE), currently yielding 9.1%, has paid a dividend in every year since 1887. Its growth rate is only 0.1%, reflecting a dividend which has fluctuated over the past seven years. The shares are trading at 18% below the 1979 high and 22% below book

value (which like Penn's is not adjusted upward). The bulk of the trust's assets are shopping centers and office and industrial buildings; nearly half are located in California. The trust has an overall vacancy rate of 7%, rather high for this group. After a hiatus of five years, the trust is beginning to expand its portfolio again, with the purchase of an office building in Waltham, Mass., in June, 1979, for \$1.0 million.

REIT of America has only \$8.7 million in mortgage debt over \$36.9 million in shareholder's equity, and thus no interest rate exposure. Property yields are improving, and property sale gains totaled 85¢/share in the first nine months of fiscal 1979, compared with 40¢/share for the entire preceding year. Decisions regarding distribution of capital gains are made following the close of the year; a 20¢/share extra dividend was paid for fiscal 1978. The No. 2-ranked shares can be purchased for yield and long-term improvement.

Florida Gulf (FGLFS-OTC) is yielding 9.1% on a price 19% below the 1979 high and 31% below adjusted book value. Longer term, the shares have not been impressive, trading only 7.7% above the price on December 31, 1973, and with a current dividend rate 19% below that paid in 1973 (the first year of operation). Florida Gulf's assets are mostly shopping centers in Florida. The trust has had recurring tenant problems, with vacancies still remaining from W.T. Grant, Food Fair, and Neisner Bros., although some of the space has been released and the outlook is improving. Earnings have begun to improve in recent periods as a result of higher percentage rentals; the big boost to the shares, however, would come from the sale of several properties which the trust is negotiating. The shares are No. 1-ranked for income (a portion of the dividend is a tax-free return of capital) and as a speculation on gains from the sale of properties.

Denver REIA (DENVS-OTC) is selling at 16% below its 1979 high but still

trades over its book value, at a premium of 12.4%. The shares are yielding a low 5.2%, largely reflecting strong gains in share price, as the growth rate of its dividend is 4.8%, higher than the mean for the group. The story is told by the 191% improvement in its share price in seven years, a near-tripling--a 67% gain in the dividend over the same period could not keep pace.

Denver's assets, all in the Denver area, are concentrated in three properties (an office building, a hotel, and a shopping center-office park) which account for 70% of the trust's portfolio and provided 73% of total revenues in 1978. In the trust's strength--its location in a small market of management expertise--lies its vulnerability--the need for continued vigor in the Denver market.

Denver is highly leveraged with \$42 million in debt over \$9.4 million in shareholders equity, but none of its debt is short-term. The trust uses a portion of its depreciation to shelter sinking fund payments on \$4.5 million in debentures from dividend requirements. In the current market, the No. 2-ranked shares lack the appeal of other trusts in regard to either price or income.

Gould Investors (GTR-ASE) is yielding 7.8% on a price 16% below the 1979 high and 35% below adjusted book value. Gould specializes in low-cost, low-visibility properties; it has been actively turning its portfolio over in recent months, with the purchases of an apartment building and the land under an industrial building, and the sale of a building for a 44¢/share gain, bringing sale gains for the first nine months of 1979 to 66¢/share.

The trust has agreed to combine with Plaza Realty; current Gould holders will own 86% of the shares of the new trust. Given the nature of Gould's properties, combined with the Gould family ownership of 35% of the shares, an acquisition of Gould had been un-

likely. The merger with Plaza, the bulk of whose \$17 million assets are non-earning, makes it even less appealing as an acquisition target.

Gould is highly leveraged with \$32 million debt over \$9 million shareholders equity; most of the debt is mortgages. The trust's yield is both lower than the mean yield for the group, and is more speculative than that of trusts with higher quality properties. The No. 2 ranking is retained, as the shares have some upside potential.

San Francisco R.E. Investors (SFI-ASE) is trading at 15% below its 1979 high and 17% below book value for a yield of 8.4%. About 70% of the trust's assets are offices, mostly leased to banks. The trust's mortgage loan portfolio has been paid down from \$33 million at December, 1974, to \$6 million and is much better positioned to ride out a recession. Operating losses caused the trust to omit dividend payments for eight quarters from 1974-1976, accounting for the 0.6% dividend growth rate since 1973. The current dividend rate remains below the payment in that year.

San Francisco still carries some foreclosed properties on its books, amounting to about 5% of assets. The properties entail only minimal operating losses; in the long term, the portfolio and earnings will improve as the properties are sold. San Francisco maintains a remodeling reserve, to cover costs of property improvements, which is deducted from cash flow before dividends are determined.

The trust has \$33 million in debt, mostly mortgages, over \$27 million in shareholders equity. Earnings for the first nine months of the year ran 46% ahead of those for the comparable year-earlier period, with further long-term potential possible as mortgage loans are eliminated and foreclosed properties are liquidated. Unicorp Financial, Canada, owns 7.2% of the shares. With most problems resolved, good yield (a portion of the 1979 dividend will be a

tax free return of capital) and substantial appreciation potential, the No. 2-ranked shares remain a long-term buy.

Virginia REIT (VARES-OTC) is selling at 30% below adjusted book value and its 1979 high for a yield of 8.0%. This trust also was relatively hard hit by the 1974-75 real estate recession, reporting operating losses and negative cash flow during this period. No dividend was paid for nine quarters, resulting in a 0% growth rate; the current dividend is still 36% below that paid in 1973.

The trust invests mostly in shopping centers and apartments; some 17% of its assets are foreclosed and non-earning and are slowly being liquidated. The bulk of those properties are unimproved. Following a 1978 refinancing, the trust can consider portfolio expansion for the first time since 1975.

In announcing its results for the nine months to September, 1979 (earnings were up 7% before refinancing losses in the 1978 period), the trust said that it had had its assets evaluated by a Blyth Eastman Dillon & Co. subsidiary, which was also evaluating the assets of an unidentified real estate entity with which the trust was negotiating. Estimated book value for the trust amounted to nearly \$19/share, a premium of 31% over net book value plus accumulated depreciation. Whether or not that amount would be realized in a sale or merger is uncertain.

The trust's \$23.6 million debt is all mortgages. The No. 2-ranked shares can be played in two ways--on their 8% yield (about 40% to 45% tax free return of capital in 1979) and long term recovery as foreclosed properties are liquidated, or as a merger/acquisition speculation for realization of estimated \$19/share book value.

PORTFOLIO: Audit and its employees own beneficially positions of less than 1,000 sh. in Homac-Barnes, First Newport, Metroplex Rl., Midland Mtg., Moraga Corp., PNB Mtg. & Rlty., and United Realty.

PERFORMANCE OF OTHER REALTY TRUST
STOCKS: ISSUES TO AVOID

Leaving the equity trusts, we want to hasten to dispel an illusion which may have been created. Do not assume that Low Price + High Yield = Buy, for that is not the case. The canny investor does not choose stocks by throwing darts at the list of new lows each day. He or she must exercise discretion, for often, share prices go lower still the next day, and a long slide down follows. The low prices and high yields of the property trusts make them attractive only because their assets are throwing off what is often inflation-protected income, and because they generally have a realizable market value above their carrying value, but this does not extend to other groups. The mortgage trusts are a case in point.

In recent issues, we have been downgrading the rankings of the mortgage trusts in reaction to high interest rates, although an examination of the following table might argue for the reverse.

Trust	Recent Price	% chg. fr. hi	% Pr. to bk	Yield
Equitable	14.38	-29%	-38%	13.9%
Lomas&Ntl	17.63	-16%	-37%	12.5%
MONY	7.50	-20%	-23%	12.3%
MassMutual	10.50	-26%	-47%	13.0%
Northwstrn	8.63	-27%	-45%	11.6%
WellsFargo	13.00	-27%	-28%	10.4%
Average	11.94	-24%	-36%	12.3%

The fallacy of this form of analysis is that both former prices and book values are meaningless in this situation. Book value has no relationship to the value of the portfolio. If these trusts were to be liquidated, the value realized would equal only what one would have to invest for a similar yield today. With interest rates at the level they are today, a substantially smaller investment in new mortgages would throw off the same income that the holdings of these trusts do, with a loan portfolio with a lower yield. Similarly, the market is

valuing the stocks of these trusts only in terms of their interest stream; that is, pricing them so that the yield equals what could be earned elsewhere--in Treasury bills or money market funds, for example. In short, the prices of these stocks are functioning in the same manner as bond prices function--they fluctuate inversely with the interest rate. However, being stocks, they do not provide the same security as bonds do.

Despite their high yield, these shares do not seem to warrant the risk of purchasing them. First, one must consider the attractiveness of alternative investments. With money market funds, even the small investor can realize similarly high yields on his or her investments, without the downside risk of purchasing stocks, and furthermore, his interest is being compounded and does not require reinvestment. While there is no upside potential, there does not appear to be much in the mortgage trust stocks either. They will appreciate only in two instances--as interest rates go down, the stock prices will go up as yields are brought into line with current market rates; and as the portfolio matures, when the book value of the outstanding loans will be realized and the proceeds reinvested in with more favorable yields. However, we do not see interest rates falling appreciably in the near future, and none of the trusts are anywhere near having their entire portfolio mature.

While there is no near-term appreciation potential in these issues, there exists considerable downside risk. The investor might be deceived by the recent strong earnings reports of the mortgage trusts as a group (see Realty Trust Review, October 26, 1979), but results for the current quarter will not be so strong. Each of the trusts has substantial short-term debt, which cuts a few cents a share each quarter for each 1% increase in the prime rate. While the trusts have been moving to cut debt and increase equity holdings, immediate, entire, transformations cannot be effected.

Earnings are further threatened by the recession. While a repeat of the 1974 debacle is not expected, and while these trusts weathered that period fairly well, they still face the problem of defaults on mortgages and consequent foreclosures if the recession is long or deep.

With a decline in mortgage trust earnings, there is also the possibility of dividend cuts. Equitable's dividend in its last quarter exceeded its earnings, while MONY Mortgage's dividend equaled earnings. Lomas & Nettleton raised its dividend to the level of its earnings. If earnings fell sharply, current yields probably could not be maintained.

Overall, the key to choosing stocks in the current market is to look beyond balance sheet book value for actual book value--the amount that would be realized if the trust were to be liquidated. Recent events indicate that the realizable value of the property trusts is somewhat over net book value. On the other hand, if a mortgage trust were to liquidate today, it would receive only a portion of stated book value. While we are not suggesting that a mass liquidation of realty trust stocks is imminent, book value is an important bench mark for the investor, because it indicates the future income potential of trust assets, and future appreciation potential of trust shares.

ACCOUNTING: EASTOVER CORP.'S KICK FROM NEGATIVE GOOD WILL: MARKET VALUE DELAYED

Almost unnoticed, Eastover Corp. has begun picking up extra earnings from other trusts whose shares it has acquired at prices below book value. By consolidating earnings of other REITs now owned more than 20%, Eastover could add perhaps \$1 million or about \$1/share to 1979 earnings.

To understand what's happening -- why we continue to rank EASTS No. 1N -- highest appeal for speculative recovery -- you have to go back to early 1978 when Jackson, Miss. stockbroker Leland

Speed led a group that acquired control, changed the name from its former First Commerce Realty Investors, and in a series of moves repaid all bank debt by June 1978.

Since then Eastover has become an aggressive acquirer of shares of other realty trusts and at latest report owns:

--31.6% of Parkway Co. (formerly Texas First Mortgage), with about \$1.46 million market value;

--29.0% of Citizens Growth Props. with about \$1.06 million market value;

--And 21.5% of ICM Realty with about \$8.8 million market value. The position is held jointly by Eastover with 486,586 sh. and Citizens Growth with 159,300 sh. (Citizens Growth recently changed its investment policy to include REIT share purchases.)

Because it reached 20% ownership, Eastover is consolidating Parkway Co. retroactive to Jan. 1 and through June reported \$234,000 or 23¢/sh. equity in Parkway's earnings. It will begin consolidating Citizens Growth soon and expects to do the same for ICM Realty, based on the combined ownership.

The added kick comes when any of the affiliates sells an asset. Because it bought all three of its blocks below stated book value of the entity, Eastover has created "negative good will" or the difference between its cost and the entity's stated book value. Under accounting rules, Eastover must allocate its purchase price against the assets of each acquired entity, and then must treat any sales of the entity's assets as if Eastover were selling assets directly. Thus, as the satellite trusts sell assets, Eastover picks up or "accretes" the negative good will difference.

How it works is best shown by an example: In its March 1979 quarter, Parkway sold an asset at essentially its cost and reported losing \$89,000 or 8¢/sh. But because Eastover's cost basis is so much lower, it reported a \$198,000 profit as its 31½% share of

Parkway's results.

In the June quarter, Eastover reported \$36,000 or 25% of Parkway's \$143,000 earnings. With the varying cost bases, Eastover's earnings are expected to differ markedly from those of Parkway and the other affiliates in future quarters.

But while these earnings are reported for public reports, Eastover cannot consolidate the tax returns because it doesn't own 80% of any one company. Thus Eastover protects its taxloss carryforward.

Operationally, Eastover has decided against seeking to merge its satellite trusts into itself. Rather, it has opted for parallel management all out of Eastover's Jackson, Miss. base. Citizens Growth became Eastover-managed on Aug. 1 and Parkway Co. will move to Jackson Jan. 1, 1980. Eastover now has one seat on ICM's board and has asked for additional representation.

Eastover hasn't yet reached putting 40% of its assets into securities, the peril point beyond which it would normally become an investment company subject to S.E.C. regulations. And the S.E.C. has shown some recent willingness to give on the 40% level.

Meantime, the Financial Accounting Standards Board has delayed mandating current value accounting for real estate companies for the time being. "The board believes there may be net benefits in disclosure of measurement of net present value of income producing properties but further study is needed in implementation," the Board said. A thorough study and follow-up report is promised for 1980.

The decision means real estate companies above certain minimal sizes will be required to make mechanical adjustments of their historical cost numbers in future reports, a method generally regarded as less than satisfactory for real estate companies. In postponing action on real estate, FASB encouraged

experimentation on current value. We interpret this to mean that current value accounting is coming for real estate companies and trusts, but that timing and format remain unsettled.

In this environment, Audit will continue its practice of adjusting book value for REITs paying depreciation as part of their dividend. Audit adds back accumulated depreciation to net book value for these trusts; components are shown in Relative Appeal Ranking issues.

BANKRUPTCIES: GUARDIAN MORTGAGE WINS CREDITOR OKAY AFTER RAISING CASH PAID

Guardian Mortgage Investors has obtained creditor approval of its previously announced plan of arrangement under Chapter XI. The U.S. court hearing the case will consider confirmation at a hearing Dec. 20.

To win approval, Guardian sweetened its earlier plan to win acceptance of that plan by an unofficial committee of note and debenture holders. As a result, bondholders will get the following for each \$1,000 principal:

--7½% senior subordinated notes: \$310 in cash (up from \$260 in the original plan), plus 254 shares of stock.

--6-3/4% subordinated debentures and 8% convertible subordinated debentures: \$220 cash (up from \$210 before) plus 188 shares of stock.

If the court confirms the plan, current GMI shareholders would be left with 16% of the company, while subordinated debtholders would get 42% and commercial banks the other 42%.

Guardian's banks would be paid \$83 million on settlement, including \$25½ million cash and the rest in transferred properties. Banks would agree to accept zero interest on the remaining \$121 million debt, which is due through 1990, plus half of net cash recoveries on non-core properties sold through 1990.

Guardian would continue mainly as owner and developer of seven core residential properties, all in Florida.